

**INTERNAL REVENUE SERVICE OVERSIGHT BOARD  
PUBLIC MEETING  
FROM A STAKEHOLDER'S PERSPECTIVE:  
ASSESSING THE IRS's PERFORMANCE  
January 27, 2003**

Mr. Chairman and other members of the IRS Oversight Board, the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am Robert A. Zarzar, Chair of the AICPA's Tax Executive Committee. Joining me today is James A. Dougherty, Chair of the AICPA's IRS Practice and Procedures Committee. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from the broad base of experience that we offer our comments today.

We are pleased to provide comments that assess the IRS's performance on critical tax administration programs. Specifically, the IRS Oversight Board has raised questions about (1) the future direction of electronic tax administration, (2) enforcement challenges, (3) effective collection strategies, and (4) workforce empowerment.

**I. FUTURE DIRECTION OF ELECTRONIC TAX ADMINISTRATION**

**A. Proposal Extending the Due Date for Electronically Filed Returns**

The AICPA supports the IRS's long-range goals for electronic tax administration in general, and electronic filing (ELF) in particular. However, we are particularly concerned about the proposal to extend the due date for electronically filed individual returns to April 30. The initiative, proposed by Treasury and given serious consideration to by the last Congress, is likely to be reintroduced in the 108<sup>th</sup> Congress. Although we applaud the creativity of this proposal, the same incentive could be achieved without changing the due date by deferring the processing of electronic payments on e-filed returns until April 30. This would avoid the complexities and problems – detailed below – of a separate e-filing due date.

The Incentive to E-File

Most taxpayers who file electronically do so to accelerate the processing of refunds. Treasury's proposal would provide a similar cash-flow benefit for "tax-due" returns by allowing taxpayers to hold onto their cash until April 30. It is difficult to predict how much of an incentive this delay would provide, given that the difference between an immediate charge on April 30 and the slower processing of checks mailed on April 15 might result in additional "float" of less than a week. However, the delayed due date

would at least remove the e-filing disincentive of immediate electronic payment on April 15.

The public and practitioners continue to have concerns over electronic filing; this cash flow incentive may be an important factor in the decision to e-file. Predominant among these concerns are, contrary to IRS advertising: (1) e-filing does not reduce tax paperwork for taxpayers and practitioners; (2) computer-prepared paper returns are no less accurate than those submitted electronically; and (3) e-filing is more – not less – expensive. Finally, there are lingering concerns about privacy and the government’s ability to collect more information from electronically filed returns than from paper returns.

In light of these continuing considerations, we believe that deferred processing of electronic payments on e-filed returns until April 30 would achieve the same cash flow incentive to e-file as would a delayed filing date.

#### Return Processing Problems

Under Treasury’s proposal, taxpayers would gain the maximum cash-flow benefit by filing on April 30. This last-day (and potentially last-minute) rush of returns would cause processing problems for practitioners and the IRS, and could cause some returns to be filed late as a result of processing log-jams. By processing electronic payments from e-filed returns on April 30 – no matter when the returns were filed – the IRS and practitioners could process electronically filed tax-due returns normally throughout the tax season, but still retain the maximum incentive to e-file.

#### Estimated Tax Payment Problem

Treasury’s proposal does not extend the due date for estimated payments, although crediting of overpayments of prior years taxes is considered timely through April 30 on e-filed returns. Without a general extension of the estimated payment due date, taxpayers might have to substantially complete an e-filed tax return by April 15 and timely make their estimated payments within the safe harbor based on prior year’s taxes. Also, by allowing overpayments on April 30 e-filed returns to be timely credited towards estimated taxes that would otherwise be due on April 15, this may result in differing due dates for some Federal and state estimated tax payments (see discussion of state tax conformity below).

#### Federal Extension Problems

As an alternative to filing their individual returns on April 15, taxpayers may request an automatic four-month filing extension. Treasury’s proposal does not address whether this automatic extension would be lost if a taxpayer who intended to e-file by April 30 was unable to do so and had not filed an extension by April 15. This could occur, in a variety of relatively ordinary circumstances; if, for example, the taxpayer died between April 15 and April 30, or there was a processing glitch such as where someone else erroneously

filed using the taxpayer's social security number or where an error is made in copying an employer identification number. Without an additional opportunity to file an extension before May 1, prudent taxpayers and practitioners would file extension requests on April 15 even if they plan to file the return electronically by April 30. This could result in the IRS receiving an extension request for every e-filer expecting to take advantage of the later due date. Finally, if a taxpayer could file for an automatic e-filing extension on April 30, the legislation should clarify that the extended due date would be August 15, not August 30 or 31. Deferred processing of payments for e-filed returns, instead of a later due date, would avoid these problems.

Deferred processing of electronic payments would also give the government an opportunity to encourage e-filing of extended individual returns. If the government deferred processing of electronic payments for 15 days where an extended return is filed electronically, this would provide a powerful cash-flow incentive to e-file many extended returns. Again, the IRS could easily accomplish this change, without adding complexity or changing the tax law. As currently drafted, Treasury's extension proposal provides no e-filing incentive for extended returns.

### State Tax Conformity

Changing the due date for federal e-filed returns causes a number of potential problems for taxpayers and state and local governments. Unless state and local governments conform their laws to the April 30 due date for e-filed returns:

- Taxpayers would have to prepare their federal returns by April 15 in order to prepare their state returns.
- States could see a substantial increase in the number of extensions because federal returns were not completed by April 15.
- Many states require a copy of a federal extension request as part of a state extension request; April 30 e-filers could not comply with that requirement if they did not request a federal extension.
- Taxpayers could erroneously assume that their electronically filed state tax return is due on the same day as the federal return, resulting in state late-filing penalties.
- The timely crediting of overpayments of prior year's taxes against current year's estimated taxes, allowed by this proposal for federal returns filed on April 30, would result in state late-payment penalties unless states conform their rules or taxpayers continue to pay state estimated taxes by April 15.

Thus, unless states change their laws to conform with an extended federal due date for e-filed returns, much taxpayer confusion and state tax filing complications could result. Care should be taken to give states enough time to enact conforming legislation to avoid these problems. These state tax conformity issues would not arise if the federal government simply defers processing of electronic payments until April 30 rather than extending the due date.

## Complexity

The Treasury proposal would create different rules – based on filing method – for return due dates, tax payments, and filing extensions. Many of these rules are already complex. Multiplying this complexity by the number of filing rules would add another layer of confusion. Deferring electronic payment processing rather than extending the due date offers a much simpler approach to promoting e-filing.

## Maintain April 15 as the Well-Known Filing Date

April 15 has been engraved into our national psyche as the date by which we must take some action on our taxes. Although one intent of this proposal is to help people who have trouble getting organized by April 15, we suspect that further delay in getting organized may result merely in creating one last haven for procrastinators.

In general, tax practitioners would prefer a firm deadline, not easily by-passed, to lend some finality to the annual crush of tax return work. Practitioners do not relish extending their busy season 15 days and creating a last-minute April 30 push to take maximum advantage of the “float” on tax-due returns.

We believe that returns should continue to be due by April 15, with deferred processing of electronic payments on e-filed returns. This would keep April 15 as the date by which taxpayers must address their tax obligations, but still provide e-filing incentives.

### **B. The More Likely Than Not Standard**

We also wanted you to be aware of another serious concern. Last year S. 2498, the *Tax Shelter Transparency Act*, contained a proposal that we believe will undermine the e-filing program.

In a self-assessment system such as ours, taxpayers are expected to report their transactions in accordance with the rules prescribed by the income tax laws. However, given the complexity of our tax laws and the many issues awaiting administrative guidance from the Treasury Department and the IRS, Congress has wisely built into the system the flexibility to reasonably interpret the many grey areas of the law without the threat of having penalties imposed where such interpretations are challenged by the IRS and tax deficiencies assessed.

Currently, **taxpayers** do not face penalties with respect to tax deficiencies assessed on non-tax shelter (“non-tax avoidance”) transactions if either (1) the taxpayer is considered to have had “substantial authority” (i.e., the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions or roughly between a 33.3% and 50% likelihood of prevailing) for the tax treatment it reported for such transaction on its tax return, or (2) the taxpayer made a special disclosure of the transaction and there was a “reasonable basis” (i.e., a relatively high standard of reporting that is significantly higher than not frivolous or roughly a 20%

likelihood of prevailing) for the tax treatment it reported for the transaction on its tax return. On the other hand, taxpayers currently face penalties on tax deficiencies that are assessed with respect to tax shelter (“tax avoidance”) transactions, unless they can establish that they held a “reasonable belief” that the tax treatment shown on their tax returns with respect to such transactions was “more likely than not” (i.e., a greater than 50% likelihood of prevailing) the proper treatment.

**Tax return preparers** currently do not face penalties with respect to understatements of tax on tax returns, regardless of whether attributable to a non-tax shelter (“non-tax avoidance”) or tax shelter (“tax avoidance”) transaction, if the preparer either (1) had a good faith belief that there was a “realistic possibility of success” (i.e., roughly a 33.3% likelihood of prevailing) for the tax treatment of such transaction being sustained on its merits, or (2) made a special disclosure of such transaction and the tax treatment reported for such transaction was “not frivolous” (i.e., not patently improper and would be far below a 20% likelihood of prevailing).

S. 2498, in its present form, would affect **all returns filed** because it elevates the reporting standard for both taxpayers and tax preparers on **all return items** to the very highest standard now imposed only on tax shelter items – the “more likely than not” standard. In short, the bill would subject both taxpayer and tax preparer to penalties for **any** reported return position on business or personal returns unless (a) the position was specifically disclosed or (b) both taxpayer and preparer reasonably believed the return position was “more likely than not” the correct position.

The AICPA is concerned that this contemplated change would be a burden to many taxpayers, would not necessarily create the desired result – weeding out abuses in the system – and would make CPAs consider recommending that all clients file disclosures on virtually any return item on which there is the slightest question. Clearly, this is not a desirable outcome, nor is it likely to focus attention on potentially abusive tax avoidance transactions. **The IRS would be swamped with paper; e-filing would be undermined; important disclosures would be overlooked, and a large percent of these voluminous disclosures would be meaningless.**

Given the complexity of the rules and the lack of guidance from the Treasury Department and the IRS, the “more likely than not” standard has wisely been reserved for “tax avoidance” transactions rather than imposed as a uniform rule for all transactions.

## **II. ENFORCEMENT CHALLENGES**

### **A. The IRS’s Enforcement Agenda**

The AICPA appreciates the IRS Oversight Board’s concerns regarding how non-compliance and aggressive taxpayer behavior threatens to overwhelm IRS resources. To counteract these tax administration trends, the IRS has announced a number of major compliance initiatives. Tax shelters are the primary focus for the Large and Mid-Sized Business (LMSB) Division. The Small Business/Self-Employed Division is emphasizing

offshore credit cards, the unreported income and underreporting of income by high-income taxpayers, and promoter investigations and abusive schemes.

These LMSB and SB/SE initiatives are resource intensive, and will change the allocation of resources which would otherwise fund enforcement initiatives targeting traditional and mainstream taxpayers. In order for the IRS to maintain a high level focus on compliance areas like tax shelters and abusive schemes, the IRS is forced to focus its remaining resources on mainstream taxpayers by principally basing their examination and collection efforts towards these taxpayers on the concept of materiality; that is, by emphasizing the more material issues under investigation. This materiality focus underlies the IRS's efforts to reengineer the examination and collection efforts.

## **B. Reengineering of Examination**

The AICPA supports the goals behind the reengineering the examination function. These goals include: (1) streamlining the examination process, by reducing the taxpayer's time and expense in responding to an IRS examination, (2) increasing SB/SE's effectiveness and timeliness in examining returns, and (3) enabling the Service to reduce and redirect resources to major compliance initiatives.

At the beginning of the "reengineered examination" audit, the examiner and taxpayer will conduct an audit engagement meeting; it is expected that the examiner and the taxpayer will discuss the audit issues, the information needed for resolution of the examination, and the time estimated to complete the audit. The IRS expects to establish materiality guidelines for examining critical audit issues, and for manager involvement in the early stages of the audit to facilitate quick and effective problem resolution.

Like SB/SE's examination reengineering initiative, LMSB has announced its Limited Issue Focus Exam (LIFE) program. LMSB Commissioner Larry Langdon recently stated that this program is the Service's "gold-card" treatment for taxpayers "who want to be cooperative and professional in sharing documents." Under LIFE, the IRS will start building its case before referral to a Revenue Agent by identifying the material issues for review. LMSB expects to conduct a periodic review to ensure that Revenue Agents are not routinely extending the scope of the audit beyond the material issues that have been identified during the case building stage. The IRS and taxpayer would sign a memorandum of understanding at the start of the audit outlining the examination's focus.

We recommend that the IRS Oversight Board support the IRS's quest to reengineer the examination function. These efforts are constructive ways to better target the overall scope of examinations; and practitioners believe the reengineered process offers significant opportunities to reduce taxpayer burden in terms of the time and cost of an examination.

### **C. Schedule K-1 Matching Program**

The AICPA commends the IRS for having taken prompt action in August 2002 to suspend its compliance initiative involving Schedule K-1 matching. This action was taken in response to the high error rate the IRS was experiencing with notices suggesting that a "mismatch" existed between what was stated on a Schedule K-1 and what was reported on the individual's tax return for tax year 2000. It is our understanding, that out of the 65,000 notices mailed to taxpayers last summer, the "no change rate" involving those notices exceeded 50 percent. This means that over half the taxpayers -- who received Schedule K-1 notices under this program last year -- ultimately did not have any increase in their tax liability.

We shared with the IRS, in a letter dated September 18, 2002, a number of problems tax payers experienced with the K-1 matching program. These examples suggest that the IRS often failed to (1) track a flow through entity's suspended losses or credits from prior years, (2) take into account supplemental information contained on the Schedule K-1, (3) recognize that income information (relating to a succeeding year) did not apply to the current year, and (4) consider a taxpayer's share of legitimate offsetting deductions against partnership income. For the benefit of the IRS Oversight Board, we have attached a copy of our September 18, 2002 letter.

When the K-1 matching program was first implemented during summer 2002, we were particularly concerned that the Service had not requested comments and input from the practitioner community on the program's details in advance. Several times over the last 18 months, the AICPA offered -- in written communications and in meetings -- to review and comment on the IRS's plans for the K-1 matching program. On more than one occasion we urged the IRS to implement the program slowly to avoid the wholesale issuing of erroneous notices.

In the August 7, 2002 release announcing suspension of the matching program, the IRS stated that it "will be working closely with external stakeholders once the data gathering and analysis are completed to develop future policy and procedures for the K-1 matching program." We applaud and appreciate the Service's acknowledgement of its mistake that the agency had not sought input from the practitioner community about the K-1 matching program. The IRS has taken steps to meet with stakeholders in the last two months. The Service met with representatives of practitioner groups on December 6, 2002, and it met with the AICPA's IRS Practice and Procedures Committee on January 17, 2003.

The AICPA welcomes the recent opening of dialogue between IRS officials and stakeholders. As the IRS moves to re-start the K-1 matching program, we recommend that the IRS (1) reduce the agency's short-term goals for the program, and phase-in implementation of a broader, more ambitious program over an extended period of time, (2) continue to actively seek input from key practitioner and stakeholder groups, (3) make improvements in the Service's training of employees who are involved with the K-1 program, (4) develop new outreach programs and education materials to better inform

taxpayers and practitioners about the IRS's expectations for the program, and (5) consider design improvements in forms, like Schedule K-1 and Schedule E.

#### **D. National Research Program**

In announcing the National Research Program (NRP) about one year ago, the Service stated that the program was designed to “*accurately* measure tax compliance while minimizing the need to contact taxpayers during the process.” According to the IRS, the program will enable the Service to establish better compliance initiatives for the purpose of more effectively catching tax cheating and encouraging all taxpayers to pay their fair share of tax. Also, the National Research program, as proposed, will measure filing compliance, payment compliance, and reporting compliance.

We are closely watching the development and implementation of the new research program. We are well aware the IRS has not updated its audit research tools for tax returns in more than 14 years. For this reason, the AICPA conceptually supports the development by the Service of new audit research tools to replace outdated audit formulas. To the extent a new research program can contribute to a reduction in the “tax gap” and yield a reduction in taxpayer burden over the longer term, we are supportive of such an approach. However, we are concerned about the creation of any research program that might once again result in time intensive, intrusive “line-by-line” audits of taxpayers.

Unlike the problems associated with the rollout of the K-1 matching program, the IRS has done a commendable job of seeking input from practitioners and taxpayers about the agency's plans to implement the NRP. The IRS has met with the AICPA to discuss a number of the Service's conceptual plans for implementing the program, and the Service has invited practitioner participation in some of the initial training sessions for the IRS personnel who will be conducting the NRP audits.

The AICPA will be observing with the hope that a more “flexible approach” is in fact utilized by IRS revenue agents and auditors working under the National Research Program. It is important that taxpayers and their representatives know as much as possible about the program, thereby reducing the likelihood that the effort will be subjected to the emotional and political barrages that have occurred in the past.

We are encouraged that then Commissioner Rossotti stated last year the IRS will “put much of the burden on the IRS to do our own research before we go taking information [under the program] from the taxpayer.” Based on our experiences with the IRS's current efforts to reach out to practitioners and taxpayers, it does appear that the IRS is moving in the right direction to implement the NRP research initiative in as transparent a manner as possible.

### **III. EFFECTIVE COLLECTION STRATEGIES**

The AICPA strongly supports IRS implementation of effective collection strategies designed to improve taxpayer compliance. Three particular collections areas that we believe warrant careful consideration are the Offer in Compromise program, the frivolous filing penalty, and the growing burden of collections cases thrust upon Appeals.

#### **A. Offer in Compromise User Fee**

The IRS issued proposed regulations on November 5, 2002 that would impose a \$150 user fee for Offer in Compromise filings. However, the user fee would not be imposed on Offers: (1) filed by “low income” taxpayers; (2) based on doubt as to liability; (3) based on doubt as to collectibility due to economic hardship; or (4) which promote effective tax administration.

The AICPA commends the Service for seeking to alleviate its workload in processing Offers in Compromise, a burden that often results in taking more than a year to process, evaluate, or reach a final determination on an Offer. Nevertheless, we are concerned that the proposed regulations do not address the dire need to improve customer service in the Offers in Compromise program. We fear that taxpayers will pay a new fee without receiving improved customer service or reduced processing time in return.

We generally do not support the IRS’s proposal because the user fee would place additional administrative and financial hardships on taxpayers. Instead, we suggest that consideration be given to a broadening in the scope of the frivolous filing penalty to cover frivolous Offers. We view this penalty proposal as potentially a more effective means of addressing problems with administering the Offer program. (See subsection C below, “Frivolous Tax Returns and Submissions.”)

#### The Concept of Imposing a User Fee

Based on our review of user fees in other IRS programs, the AICPA believes that the proposed Offer in Compromise user fee is not consistent with the use of such fees in other administrative programs. Most user fees routinely involve voluntary requests for advice from the Service, such as private letter rulings and determination letters. Moreover, we do not agree with those who suggest that an Offer user fee is similar to the current \$43 fee assessed to set up an Installment Agreement. This Installment Agreement fee reimburses the IRS for the costs associated with monitoring and administering the Installment Agreement program over an extended period of time. In contrast, filing an Offer in Compromise is not a voluntary request for IRS administrative guidance. Rather, an Offer is a request of last-resort for administrative relief; one that provides the taxpayer with a possibility of making a fresh start financially.

### Taxpayers' Inability to Pay the User Fee

To the extent a taxpayer does not qualify for an exemption from payment of the user fee, section 300.3(b)(3) of the proposed regulations states that “the fee will not be refunded to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as nonprocessable after acceptance for processing.”

Many practitioners feel that the IRS uses overly rigid criteria in processing and evaluating Offers. As a result, they fear that clients will be forced to pay multiple user fees, because clients must often submit Offers two or three times before reaching final resolution of their tax problem. These practitioners believe the user fee is being proposed solely to discourage taxpayers from filing Offers in Compromise, particularly since persons who file Offers typically have insufficient funds or lacks financial resources.

Under certain circumstances, the AICPA respects the need to establish user fees that are fair and reasonably approximate governmental costs for administering a program. Although we don't agree with the suggestion that the user fee is being imposed solely to discourage Offer filings, we doubt that this user fee will result in any meaningful revenue increases for the IRS's administrative budget or even for the U.S. Treasury.

### Cost of Administering the User Fee Program

Administering a new user fee program is not cost-free. Systems must be created to determine who is required to pay, and when refunds or exemptions from payment are appropriate. As previously stated, there will be a waiver (or in some cases, a refund) of a user fee for taxpayers filing Offers involving doubt as to liability, low income status, or Offers based on effective tax administration or economic hardship grounds. In all likelihood, a specific form, accompanied by potentially complex instructions, will be needed to apply for, and explain the grounds for waiver of, the fee. These costs will further reduce any revenues the Service hopes to collect from the fee.

### The Definition of Low-Income

The proposed regulations would exempt low-income persons from paying the user fee. A low-income person is defined under the regulations as a taxpayer falling at or below the Department of Health and Human Services' annual poverty guidelines – for 2002, \$18,100 for a family of four.

This definition of “low income” is too low and would force many taxpayers of limited means, who happen to earn more than the HHS poverty guidelines, to pay the user fee. A more equitable – and consistent – definition for low-income can be found in IRC section 7525(b)(1)(B). This Code section defines a low-income taxpayer clinic (among other criteria) as a facility that represents taxpayers who generally do not have incomes exceeding 250 percent of the poverty level. If \$18,100 represents 100 percent of the poverty level for a family of four, then 250 percent of the poverty level amounts to

\$45,250. Few, if any families of four with incomes of \$18,100 or less pay any tax at all, and are unlikely to use the Offer in Compromise program.

## **B. The Case Burden of IRS Appeals**

There is a growing dominance of collections cases in Appeals. The emergence of this collections workload burden for Appeals is a direct result of the enactment of the IRS Restructuring and Reform Act of 1998. Collection cases comprise half of the current Appeal's workload, with 30,000 new collection due process cases in the last year and a growing caseload of Offers in Compromise.

Appeals has announced a number of modifications to address its workload, including moving to a geographically based structure. This includes an expansion of a Service Center presence with the goal of locating the Appeals workforce closer to the source of work. Appeals believes a Service Center presence creates advantages such as (1) providing new career paths for employees, (2) decreasing the processing time of cases, and (3) creating the potential for issue specialization. Other Appeals programs designed (in part) to address a heavy caseload include fast track mediation; and the Mutually Accelerated Appeals Process (MAAP), which strives to reduce the cycle time for large cases.

The AICPA strongly supports the fast track mediation program. Unlike an arbitrator who does have settlement authority, a third party mediator acts as a facilitator for communication between the taxpayer and the government by helping the parties develop options for resolution of the case. While the fast track mediation program started out principally as an LMSB program, it is now generally available for use in all non-docketed cases and for collection related work, including trust fund recovery penalty, Offers in Compromise, and collection due process cases. However, fast track mediation is not available for issues designated for litigation, issues where there is a conflict between the courts, Service Center and ACS cases, and collections Appeals program cases.

## **C. Frivolous Tax Returns and Submissions**

Under current law, the IRS has the authority to impose a \$500 civil penalty against individuals who file frivolous original or amended returns. While not enacted into law, several bills were introduced in the last Congress (which contained an identical proposal) to address submissions raising frivolous positions or intending to delay or impede tax administration. This proposal would modify present law by (1) increasing the frivolous filing penalty to \$5,000 and (2) expanding the penalty's scope to cover collection due process hearings, installment agreements, offers-in-compromise, and taxpayer assistance orders. The bill would also require the IRS to publish a list of positions, arguments, requests, and proposals that the Service has determined to be frivolous.

The AICPA supports increasing the frivolous filing penalty to \$5,000 and the proposed expansions in its application. However, we would not want the frivolous penalty proposal to be used to stifle -- overtly or inadvertently -- legitimate taxpayer submissions

involving collection due process hearings, installment agreements, offers in compromise, and taxpayer assistance orders.

Although we are pleased that the proposal would require the IRS to publish guidance regarding what constitutes a frivolous position, we recommend expanding this requirement to also provide guidance regarding the meaning of the legislative language (from last Congress) involving "a desire to delay or impede the administration of Federal tax laws." It is particularly critical that the guidance regarding what constitutes "a desire to delay or impede the administration of Federal tax laws" be restricted to truly frivolous positions or actions. Such guidance would go along way to ameliorate concerns about the potential misuse of the expanded penalty's application, especially if the IRS consults with the practitioner community in the development of such guidance.

#### **IV. WORKFORCE EMPOWERMENT**

##### **A. IRS Employee Training**

There are many practitioners and IRS personnel who do not have a good grasp on how the overall IRS reorganization is supposed to work. When an IRS employee in the field is unsure how it implements a new program or procedure, that person will invariably fall back on his or her old ways of doing things. Nevertheless, the old way of doing things is not an option for the IRS or its employees in 2003.

Some of the most frustrating experiences realized by taxpayers and tax practitioners in dealing with the IRS occur because of a lack of training on the part of the IRS employees. It is much easier to work out a solution that is fair to both the tax system and the taxpayer if the individuals resolving the issue are knowledgeable and well trained. Given the "taxpayer segmented" nature of the new IRS organization, it is more important than ever that IRS employees acquire the technical skills and insights that correspond to the needs and issues of their different taxpayer constituencies.

The IRS needs to target meaningful resources toward the training of Service employees, particularly with the need to overcome any cultural inertia of mid-level and rank-and-file personnel toward the reorganization overall. The AICPA strongly supports such efforts. IRS executives must continue their resolve to hire and train new employees and replace its aging workforce.

We believe we can be of immense help to the Service with the training of its employees. First, whenever the IRS seeks to implement a new program, we suggest that the Service seek input from key stakeholders on the details and development of any new program. Second, the Service could benefit from the constructive suggestions of the AICPA and other stakeholders regarding materials that will be used in the training program for the new IRS initiative. Third, we recommend that the IRS utilize CPAs and other stakeholders in teaching part of the training curriculum for IRS personnel involved with any new program.

An excellent example of how this process can work and benefit the overall tax administration process is the IRS's roll-out of the National Research Program. In fact, the IRS did share the initial NRP program details and the training materials with critical stakeholders. Also, the IRS successfully utilized CPAs in the training of IRS personnel for the NRP program. We firmly believe private sector involvement in the training process helps sensitize IRS employees to the need to conduct new programs in a way that proves effective for the tax administration process, but which remains non-intrusive and minimizes taxpayer burden. By including taxpayer representatives in the training of IRS personnel, the Service will help the public learn about a new compliance program, thereby potentially mitigating the emotional, and sometimes political, reactions of the public to a new IRS program.

## **B. Coordination Between Divisions**

One of the greatest challenges for the IRS is to implement a strategy that promotes positive communications and coordination between the Large and Mid-sized Business, Small Business and Self-Employed, Wage and Investment, and the Tax Exempt and Government Entities Divisions. Such coordination is necessary to avoid confusion among the public regarding how to respond to an inquiry from one of the four operating divisions. Some early commentators on the reorganization were concerned that instead of one IRS, taxpayers might now face responding to four IRSs as represented by the operating divisions. During the last several years, IRS senior executives have done an excellent job of setting the tone for the overall organization, and the tone for proper coordination and cooperation among the operating divisions. At this juncture the IRS national office has successfully steered the organization in the direction of a united structure, overseeing its critical (but integral) components.

We encourage the Service to stay the course with respect to the reorganization. While the AICPA recognizes that the reorganization effort remains in transition, with further work to be done, we believe that the general rationale underlying the formation of the four operating divisions – focusing on specific taxpayers and their needs -- is the right one. Furthermore, we believe that any more significant changes to the IRS's organizational structure would only serve to confuse taxpayers and practitioners who only now are beginning to become comfortable with the new organization.

## **V. CONCLUSION**

The AICPA is encouraged by today's public meeting of the IRS Oversight Board. We are committed to working closely with the Board and the IRS in obtaining proper funding and operational improvements for the IRS for the coming years. We are optimistic that, with the proper plan and funding levels in place, the IRS can achieve an appropriate balance between taxpayer service and enforcement.

While we are supportive of IRS's initiatives involved with the reorganization, we believe much work remains to be done to achieve the desired level of performance or results for America's taxpayers and the tax administration overall. It is our hope that this public

meeting will serve as the catalyst for spurring positive improvements in the IRS's performance with electronic tax administration, enforcement challenges, collection strategies, and workforce empowerment. We appreciate this opportunity to offer our comments to you and would be happy to discuss any of these matters in further detail with the members of the IRS Oversight Board.

September 18, 2002

The Honorable Charles O. Rossotti  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

RE: IRS Suspension of Schedule K-1 Matching Program

Dear Commissioner Rossotti:

The AICPA commends the IRS for taking prompt action to suspend the Service's compliance efforts involving Schedule K-1 matching. We understand this action was taken in response to the high error rate taxpayers were experiencing with notices suggesting that a "mismatch" existed between what was stated on a Schedule K-1 and what was reported on the individual's tax return for tax year 2000.

When the K-1 matching program was first implemented this summer, we were particularly concerned that the Service had not requested comments and input from the practitioner community on the program's details in advance. Several times over the last year, the AICPA offered – in written communications and in meetings – to review and comment on the IRS's plans for the K-1 matching program. We have also recommended implementing the plan slowly to avoid the wholesale issuing of erroneous notices.

In the August 7, 2002, release announcing suspension of the matching program, the IRS stated that it “will be working closely with external stakeholders once the data gathering and analysis are completed to develop future policy and procedures for the K-1 matching program.” We applaud and appreciate the Service’s acknowledgement of its mistake in not seeking practitioner input on the K-1 matching program and its intention of working with the practitioner community.

The AICPA reiterates our continuing interest in (1) commenting on the K-1 matching program; and (2) providing input on problems practitioners and taxpayers are experiencing with this summer’s notices. Since the submission of the first batch of notices to taxpayers, we have collected dozens of examples and comments from CPAs regarding problems with the K-1 matching program. A sampling of these examples, in the words of the individual CPAs offering them, are attached.

The AICPA looks forward to working closely with the IRS to improve the Schedule K-1 matching program. We would be pleased to discuss this letter with you and other IRS officials.

In the meantime, if you have any questions, please contact me at (805) 653-6300 or ppecar@aol.com; James A. Dougherty, Chair of the AICPA Relations with the IRS Committee, at (202) 879-4937, or jdougherty@deloitte.com; or Benson S. Goldstein, AICPA Technical Manager, at (202) 434-9279 or bgoldstein@aicpa.org.

Sincerely,

A handwritten signature in cursive script that reads "Pamela J. Pecarich".

Pamela J. Pecarich  
Chair  
Tax Executive Committee

## **THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

### **IRS K-1 MATCHING PROGRAM**

#### **EXAMPLES OF TAXPAYER PROBLEMS**

Members of state CPA societies have provided the following verbatim examples, which demonstrate potential errors made by the IRS in the processing and submission of Schedule K-1 "mismatch" notices to taxpayers.

##### Example 1

“We have received about half a dozen [notices] now and we expect about another 100 or so in the next few months. I would imagine that there will be a reason for all of them and that this is just another poorly run program by the IRS. Not a bad idea, but terribly expensive especially since, in my opinion, about 80% of the notices will be bogus! Rarely do all K-1's match up to 1040's. There are many reasons for this, but mainly because of the fact that many flow through entities have suspended losses/credits from prior years that are now being freed up to offset current year's income. IRS isn't tracking this with their program. It is very hard to do this due to the fact that the information is located in many places (i.e., Schedules E, 8582, 6198 and basis schedules that aren't even on a tax return anywhere). So, therefore, everyone with suspended losses/credits will likely get an unneeded notice from IRS this year. . . . I don't want to cost my client more money, especially for items that are wrong and unneeded.

In my opinion, this program already needs a major overhaul and is totally absurd. Until it gets fixed, to where it captures the "real" perpetrators, this quick to react program is going to cost taxpayers millions of dollars in unneeded spending.”

##### Example 2

“One item that occurred is the supplemental information located on the K-1 is not captured and is generating a tax notice, when the filing is actually correct. Specifically, a partnership that has a 401k plan for employees and partners of the firm, reflects the K-1 with guaranteed payments to partners, grossed up, in order that the partnership returns balance. The partner's K-1 reflects the gross guaranteed payments, but in the supplemental information section of the return, has notes that indicate the partner contribution to the 401k plan is reflected in total on the K-1. When the partners file their individual return, this amount is deducted from the guaranteed payment, as it is not subject to income tax, only self-employment tax.”

### Example 3

“We had a problem with a client of ours where they received an IRS notice saying that the income information from a Form K-1 was left off of a year 2000 tax return when the K-1 was for an estate with a tax year ending Feb. 28, 2001. The income information was really supposed to be reported on a year 2001 tax return, not their year 2000 tax return. It was costly for our client to have us fix this IRS error.”

### Example 4

“So far our matching errors have resulted from proper deductions taken against reported partnership income; things like [section] 754 depreciation and interest on acquisition indebtedness. . . . [This] would suggest that if matching is desirable, then K1 form disclosures be expanded to include most common items that represent adjustments to reported income for individual partners.”

### Example 5

“I have become aware of a problem regarding the matching program. I prepared an estate income tax return that had a fiscal year that ended in 2001. The return was correctly filed on 2000 income tax forms that clearly showed the fiscal year ending in 2001. The IRS incorrectly sent out letters to the beneficiaries that included the beneficiaries share of the income in 2000 instead of 2001. The letters showed an increase in tax and penalties that were incorrect. I am sure no one looked at these notices before they were sent out. I received some angry phone calls from the beneficiaries of the estate after they received their IRS notice assessing them additional tax and penalties. This could have been avoided if someone from the IRS had looked at the notices before they were mailed out.”

### Example 6

“A client of our firm received a notice under the program. Taxpayer received 1041 K-1's that reported Income on 6a and Depreciation on 6b. The IRS failed to deduct the depreciation before making the assessment. Additionally, the taxpayer had allowable passive loss carryovers relating to the trusts that further reduced the reportable income. All information was included with the return as filed. I hope the IRS can improve on their systems to minimize this type of error in the future.”

#### Example 7

“The problems that our firm has encountered regarding matching the K-1's have all been with fiscal year partnerships and S corps. For example, an S corporation with a January 31, 2001 year-end is on 2000 forms, but would be properly reported on the taxpayer's 2001 tax return. We can usually solve the problem with a letter to the IRS; but we still need to charge the clients \$100 or so for the service. It is a real hassle to explain to the clients that it is really IRS's mistake and that we, as a firm, must charge them to correct it.”

#### Example 8

“The most frequent problem we are experiencing in the IRS K-1 matching program relates to S corporation K-1's. Many of our clients are S corporation shareholders who have acquired their interests from former shareholders. As a result, they are paying interest payments to these former shareholders, and are therefore entitled to a trade or business deduction for this interest expense. This has been clearly identified on an attachment to each shareholder's Form 1040. However, the mismatch notices are beginning to trickle in.”

#### Example 9

“As I am sure that you have already heard, IRS K-1 matching program is totally inadequate and is placing an unfair burden on the taxpayers. IRS is totally ignoring any and all business expenses associated with the K-1 income. I have even had situations where business expenses reported on the K-1, such as Section 754 depreciation, is not being considered by IRS. The task of responding to all these notices is very expensive for our firm and ultimately, our clients. I am also concerned that some taxpayers may simply pay the notice due without consulting with their CPA.”

#### Example 10

“I have had only one notice referred to me by a client so far. That may be good but it may also mean that other clients may have paid additional amounts billed by the IRS without contacting me.

The one that my client referred to me was totally in error. It appeared the IRS was only interested in matching income and did not look at the allocated depreciation deduction shown on line 6b of a Form 1041 K-1. On Schedule E of the taxpayer's 1040 the business or rental income shown on lines 6a and b of the K-1 are netted when entered for passive activities on Part III. The IRS issued a notice because the income shown on line 6a of the K-1 did not agree with the net income shown on Schedule E.

Articles have stated that IRS examiners are manually screening the returns before notices are issued. If an examiner screened this notice, he or she must have been incompetent.”

#### Example 11

“I have somehow not received a notice from any of my clients, but my partner has received one and so has another CPA I am aware of.

In both instances, the taxpayer had suspended carryover losses that IRS seemed to be unaware of. I see this as a major problem in the K-1 matching program – I don’t see any way the computers will be able to compare the K-1 with what is on Schedule E. In many cases Form 8582 is not required to be filed with the 1040 and it has additional information IRS would need to try to match. The 8582 worksheets are also not required to be filed with the 1040. Without these forms and schedules, it will be virtually impossible for IRS to match K-1s to Schedule Es.”